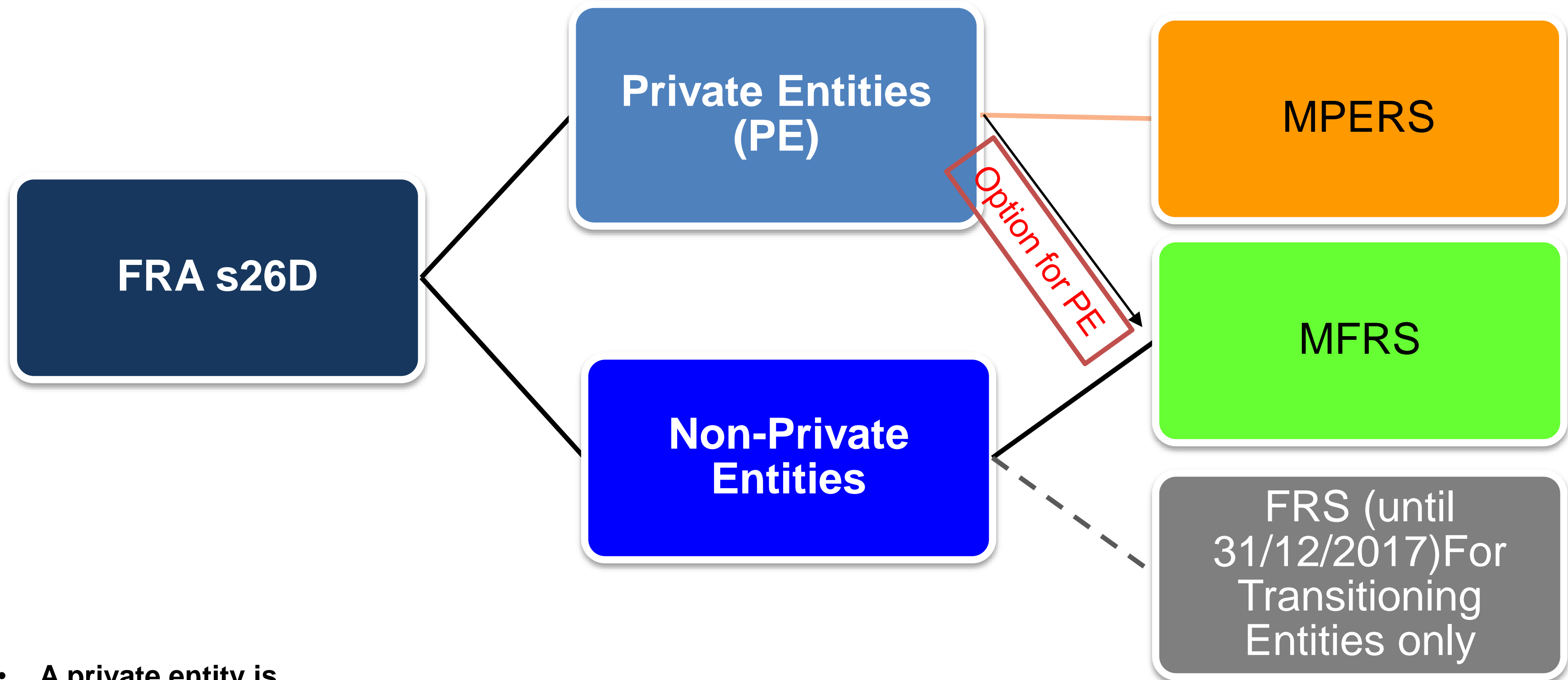
MFRS 9 FINANCIAL INSTRUMENTS

26 October 2017

MASB Financial Reporting Frameworks



- **A private entity is**
  - a private company that does not lodge financial statements to the Securities Commission (SC) / Bank Negara Malaysia (BNM)
  - a private company that is not a subsidiary or associate of, or jointly controlled by, an entity which is required to lodge financial statements to the SC / BNM

Financial Instruments Standards

- MFRS 139 - Financial Instruments: Recognition and Measurement
- MFRS 132 - Financial Instruments: Presentation
- MFRS 7 - Financial Instruments: Disclosures
- MFRS 13 - Fair Value Measurement
- MFRS 9 – Financial Instruments (w.e.f. 1 January 2018)

MFRS 9 Financial Instruments

Classification and measurement

A logical, single classification approach driven by cash flow characteristics and how it's managed

Impairment

An urgently needed and strongly supported forward-looking 'expected loss' model

Hedge accounting

An improved and widely welcomed model that better aligns accounting with risk management

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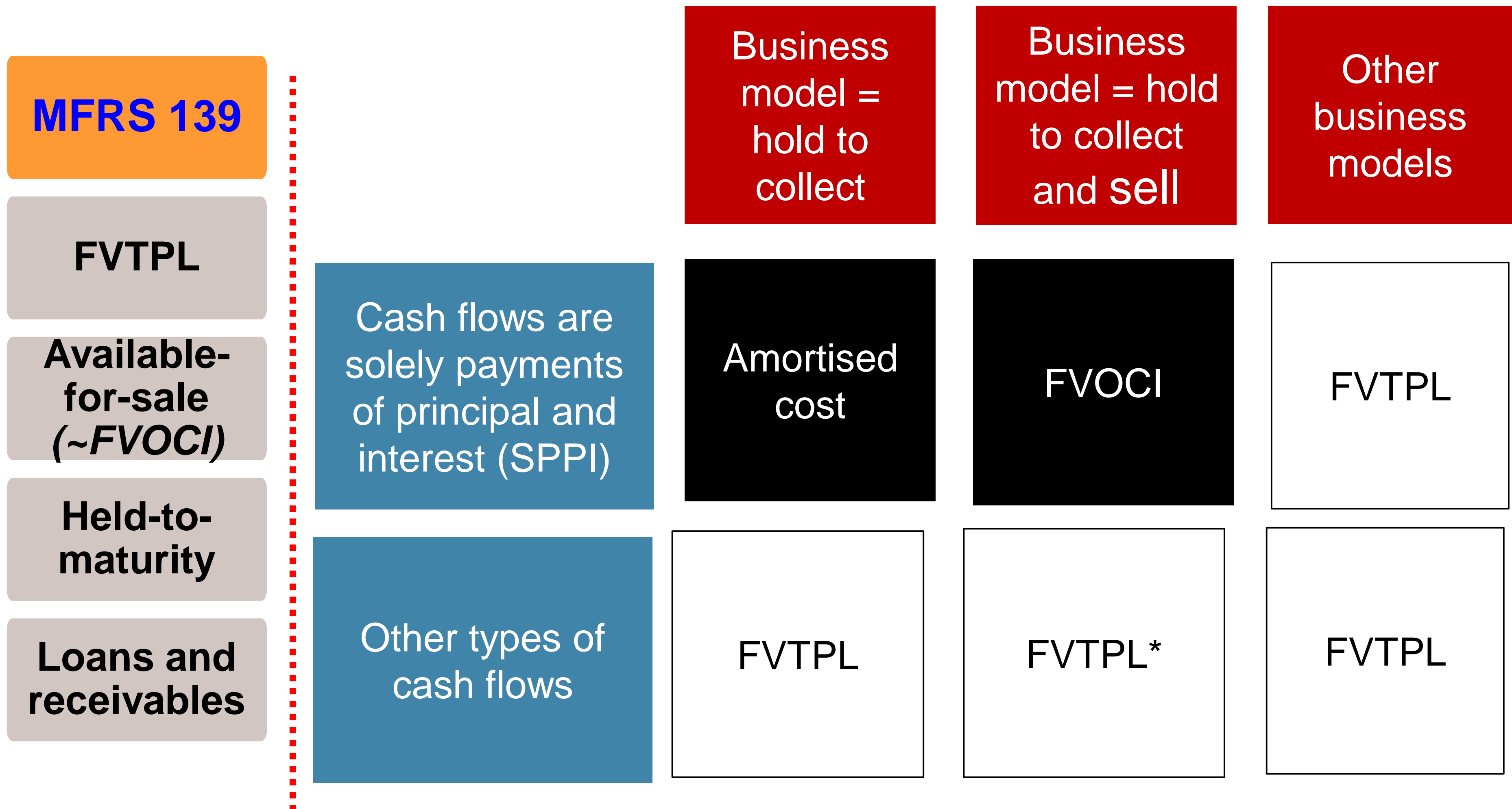
- **Classification and Measurement**

Financial Assets Classification



Business Model Test

- Factual assessment based on how assets are managed:
  - Not based on intent for individual asset
  - Typically observable through activities that the entity undertakes
  - Anchor is how cash flows are realised

- Hold to collect (amortised cost)
  - Generate value by collecting contractual cash flows
  - Consider past sales information and future expectations
  - Some sales may be consistent if infrequent or insignificant

- Hold to collect and sell (FVOCI)
  - Achieve objective by both collecting contractual cash flows and selling
  - Involves greater frequency and volume of sales
  - Liquidity needs, interest yield management, asset/liability management

Reclassify if, and only if, business model changes. Reclassification applied prospectively

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SPPI Characteristics

- Contractual cash flows consistent with a basic lending arrangement (simple instruments)
  - Comprised only of principal and interest
- Interest is consideration for:
  - time value of money and credit risk;
  - basic lending risks(eg. liquidity risks);
  - other associated costs(eg. administrative costs); and
  - a profit margin
- ‘Principal’ is the fair value of the financial asset at initial recognition
  - amount transferred by holder (fair value)
- Explicitly excludes amounts inconsistent with basic lending such as cash flows that vary with commodity prices or equity prices
- Can meet SPPI if interest is negative.

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Financial Assets : Classification and Measurement

The following financial instruments are held by Entity A.

Investment in equity instruments	Shares in private companies, held for strategic investment purposes
Investment in debt instruments	Comprises of portfolio of government securities and corporate bonds. These are held for liquidity purposes. Entity A does sell these instruments and sales are on a more-than-infrequent basis and sales are significant in value
Loan to parent company	Interest free loan is repayable in 5 years at par value
Trade receivables	A 30 day credit term is given to customers

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Financial Assets : Classification and Measurement

Investment in equity instruments – not quoted, strategic investment

MFRS 139	MFRS 9
Allows equity investment be measured at cost if these are not quoted and fair value cannot be reliably measured	No more cost override Equity instruments are measured at fair value. Entity is allowed to irrevocably present gains or losses in OCI, with no recycling
Consider impairment – significant or prolonged	No need to assess for impairment
Dividends recognize in profit or loss	Dividends recognize in profit or loss unless dividends represent a recovery of part of the cost of investment

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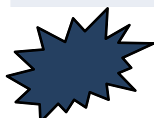
Financial Assets : Classification and Measurement

Investment in debt instruments

MFRS 139	MFRS 9
Available for sale – fair value change goes to OCI; other changes due to of EIR taken to pimpairment, amortization rofit or loss	FVOCI (meet SPPI test, business model of hold to collect and sell)
Consider impairment – significant or prolonged	Same impairment model as debt assets measured at amortized cost i.e. Expected credit loss



If the bond carries features such as conversion option or leverages, then it would likely fail the SPPI test unless the features are non-genuine or impact is de minimis

Financial Assets : Classification and Measurement

Loan to parent company

MFRS 139	MFRS 9
Loans and receivables	Amortized cost (meet SPPI test and business model of hold to collect contractual cash flows)
Assess for impairment – objective evidence of impairment	Assess for impairment ECL model

Trade receivables

MFRS 139	MFRS 9
Loans and receivables	Principal is deemed to be the amount resulting from a transaction in the scope of MFRS 15 . Amortized cost (meet SPPI test and business model of hold to collect contractual cash flows)
Assess for impairment – objective evidence of impairment	Assess for impairment ECL model

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Classification and Measurement of Financial Assets..More Examples

Solely payments of principal and interest on the principal amount outstanding

Instrument A is a bond with a stated maturity date.
Payments of principal and interest on the principal amount outstanding are linked to an inflation index of the currency in which the instrument is issued.
The inflation link is not leveraged and the principal is protected.

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Classification and Measurement of Financial Assets..More Examples

Solely payments of principal and interest on the principal amount outstanding

Instrument B is a variable interest rate instrument with a stated maturity date that permits the borrower to choose the market interest rate on an ongoing basis.
For example, at each interest rate reset date, the borrower can choose to pay three-month LIBOR for a three-month term or one–month LIBOR for a one-month term.
The entity must assess whether the payments are SPPI

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Financial Assets : Key Judgements and Effects

Cash Flow characteristics

- Technical decision
- Focus on unusual or out of the ordinary characteristics

Business model

- Matter-of-fact **not** intent
- None-the-less a reflection of internal processes
- Both strategic and operational judgement calls

Options

- Equity FVOCI option

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Impact of the Standard

Extent of impact? Vary, depending on

- the nature of the financial assets an entity holds &
- how it measures those financial assets under MFRS 139 (e.g. there is likely to be minimal impact if the financial assets are currently measured at FV through PL)

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Financial Liabilities Classification

At fair value through profit or loss

- Held for trading, including derivative liabilities that are not accounted for as hedging instruments
- Derivative liabilities that are accounted for as hedging instruments
- Fair value option — designated at inception

Amortised cost

Still subject to bifurcation for embedded derivatives.

Treatment of financial liabilities is carried forward from MFRS 139.. essentially unchanged except for own credit risk

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Financial Liabilities – "own credit" Designation under FVO

Financial statements – MFRS 9			
Balance sheet		*P&L*	
Financial liabilities –FVO	Full FV	Gain or loss	all FV Δ except own credit
		OCI	
		Gain or loss	FV Δ due to 'own credit'*

* Not recycled

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- **Impairment**

Impairment : Key Differences between MFRS 9 and MFRS 139

	MFRS 9	MFRS 139
Impairment model	▪ Single impairment model	▪ Multiple impairment models e.g ▪ AFS (debt) –objective evidence of impairment, impairment loss can be reversed through P/L ▪ AFS (equity) – significant or prolonged decline in value, impairment to be reversed through OCI
Scope	▪ Credit exposures not measured at FVTPL (include debt instruments, loan commitments, financial guarantees, lease receivables and contract assets)	▪ Loss allowance only recorded for impaired assets
Basis for recognition	▪ Expected credit loss is to be recognized at all times in a forward looking approach that reflects changes in credit risk of the financial asset since initial recognition	▪ Recognition of credit loss only when there is evidence of a trigger event i.e. objective evidence of impairment
Basis of measurement	▪ 12 month expected credit loss or ▪ Lifetime expected credit loss is recognized if there is a significant deterioration in credit risk. Expected credit loss can be reversed by subsequent favorable changes	▪ Difference between asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate. Losses that are expected to arise from future events are not recognised

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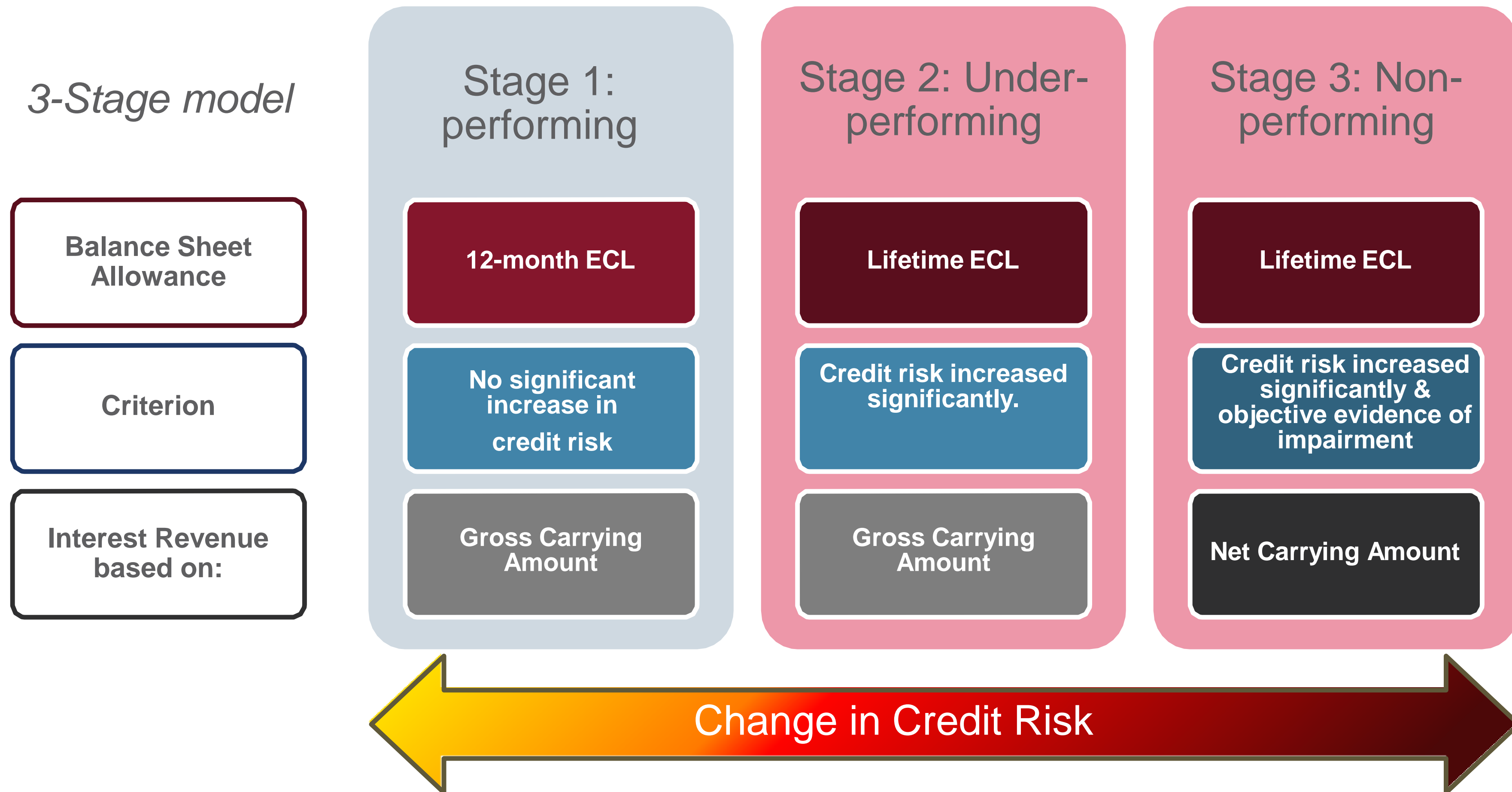
MFRS 9 Impairment: Expected Credit Loss Model



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What Are 12 month Expected Credit Losses

- Proxy for adjusting interest rate for initial expected credit losses
- Expected shortfall in all contractual cash flows given probability of default occurring in next 12 months

NOT*: Expected cash shortfalls in next 12 months*

Credit losses on assets expected to default in next 12 months

Example:

- Portfolio of 10m loans
- Expect 2% to default in next 12 months *(12-month PD)*
- Entire loss that would arise on default is 10% *(LGD)*
- 12-month expected loss = 20,000 (2%x10%x10m)

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Exceptions to the General Model

Simplified approach

- **Trade receivables & contract assets**

➢ Trade receivables & contract assets that do not contain a significant financing component => *must always measure the loss allowance at an amount equal to lifetime ECL*

➢ Trade receivables & contract assets that contain a significant financing component => *accounting policy choice to measure the loss allowance at an amount equal to lifetime ECL*

- **Lease receivables**

➢ Accounting policy choice to measure the loss allowance at an amount equal to *lifetime ECL*

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Calculating ECL for Trade Receivables—Practical Expedient

	Current	1-30 days past due	31-60 days past due	61-90 days past due	90 days past due or more
Default rate (A)	0.3%	1.6%	3.6%	6.6%	10.6%
Gross carrying amount ($) (B)	15,000	7,500	4,000	2,500	1,000
Lifetime ECL (A) * (B)	45	120	144	165	106

Determining Whether Credit Risk Has Increased Significantly—Practical Expedients

Financial instruments that have low credit risk at the reporting date

- if a financial instrument is determined to have low credit risk at the reporting date, an entity may assume that the credit risk of the financial instrument has not increased significantly since initial recognition.
- an example of a low credit risk instrument is one that has an investment-grade rating.

More than 30 days past due rebuttable presumption

- regardless of the way in which an entity assesses significant increases in credit risk, there is a rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due.

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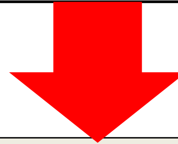
- **Hedge Accounting**

Hedge Accounting

Feedback on IAS 39: *Recognition and Measurement*

- Lack of an overarching principle; complex and rule-based
- Inability for **preparers** to reflect hedges in financial statements
- Hard for **users** to understand risk management practices



Solutions in IFRS 9: *Financial Instruments*

- Align accounting treatment with risk management activity
- Enable **preparers** to better reflect hedging in financial statements
- Provide disclosures to help **users** understand risk management and its impact on the financial statements

Major Improvements

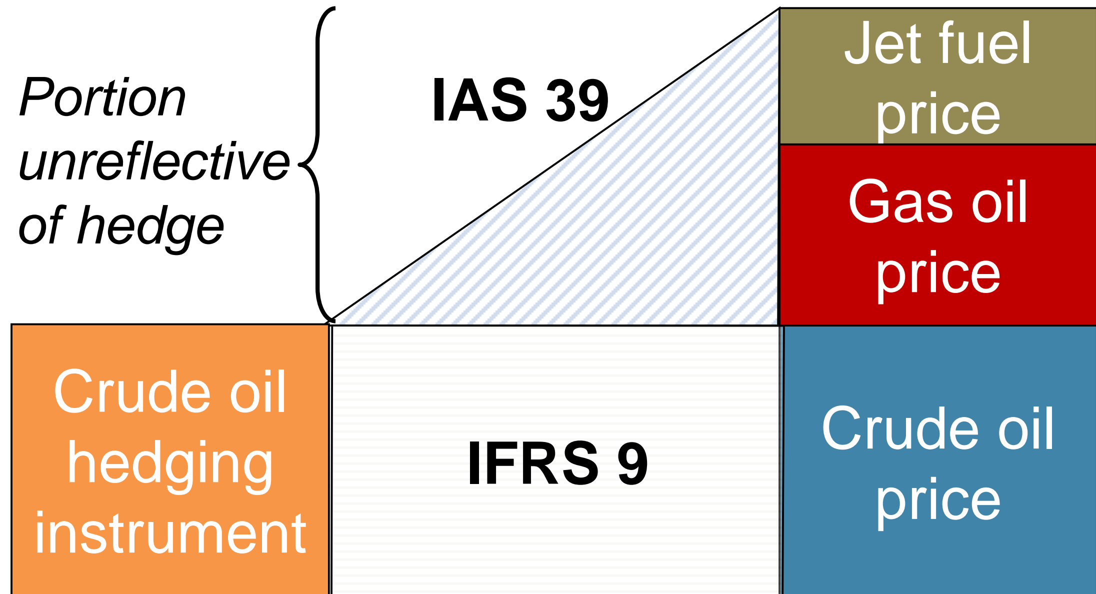
- Ability to designate risk components of non-financial instruments
- Ability to hedge aggregated exposures (combinations of derivatives and non-derivatives)
- Introduction of 'costs of hedging' to improve the transparency around some hedging instrument
- A principle-based hedge effectiveness assessment to achieve hedge accounting
- Disclosures that meet the objectives of understanding the risks being hedged; how those risks are managed; and the effect of hedging those risks.

A new approach to how accounting interacts with risk management

Example – designate risk component

Measuring the success of hedging jet fuel contracts with crude oil futures

Example: Measuring the success of hedging jet fuel contracts with crude oil futures



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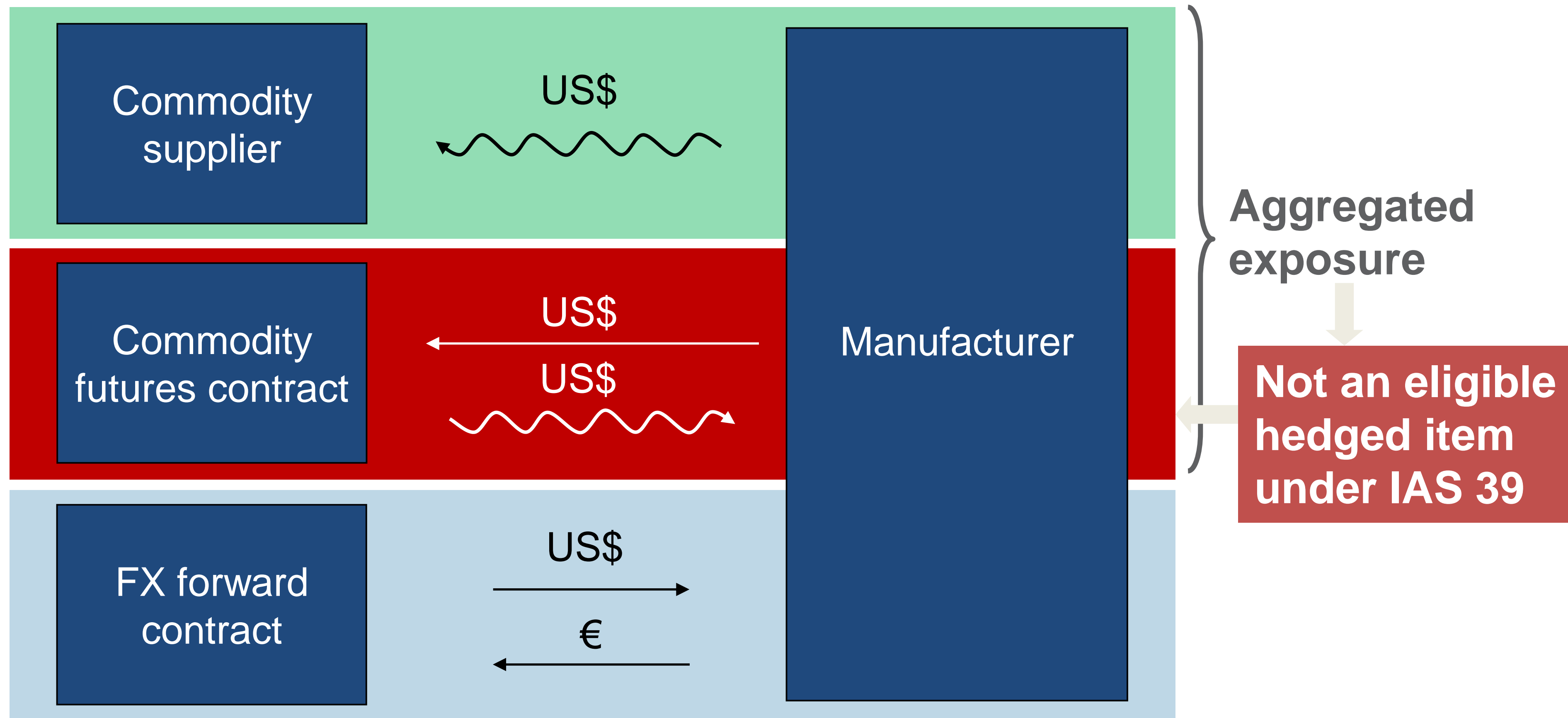
Example – hedging aggregate exposure

Example: hedging commodity price & FX risk



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Hedge Effectiveness

Hedge effectiveness	Hedge ineffectiveness
Extent to which changes in the fair value or the cash flows of the hedging instrument **offset** changes in the fair value or the cash flows of the hedged item	Extent to which the changes in the fair value or the cash flows of the hedging instrument are **greater or less than** those on the hedged item

- *Measurement* of ineffectiveness unchanged.
- Assess hedge effectiveness requirements at the inception of the hedging relationship, and on an ongoing basis (ie at a minimum, at each reporting date or upon a significant change in the circumstances, whichever comes first)

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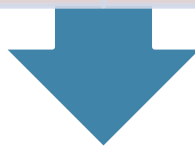
Discontinuing Hedge Accounting

Discontinue hedge accounting if:

Hedging relationship ceases to meet qualifying criteria	ie hedging instrument expires or is sold, terminated or exercised



- Discontinue hedge accounting prospectively
- Partial discontinuation possible

Can no longer *voluntarily* discontinue hedge accounting but MUST discontinue if no longer meet the qualifying criteria

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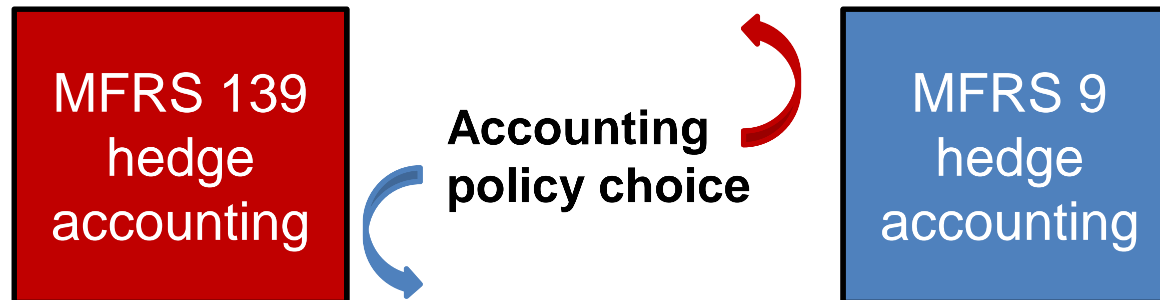
Separate Project on Macro Hedging

Concerns about macro hedging are the source of the current EU carve-out

For now entities can choose to keep using MFRS 139



Some banks may not make any changes to their hedge accounting at this time

- The IASB is simultaneously working on a specific project to consider accounting for macro hedges

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Transition and effective date

- MFRS 9 shall be applied for or on annual periods beginning 1.1. 2018.
- Retrospective except for some exemptions
- No need to state prior periods. Differences between previous carrying amount and amount at the beginning of the annual period are taken to opening retained earnings / equity
- If an entity restates prior period, the restated financial statements should reflect all of the requirements of the new standard
- MFRS 9 does not apply to FA and FL that have been derecognized at the date of initial application. At the restated financial statements, information relating to derecognized FA and FL will continue to be reported in accordance with MFRS 139

Transition – classification and measurement

Business model

Made on date of initial application (DIA) based on facts and circumstances at DIA. Resulting business model to be applied retrospectively regardless of entity's business model in prior periods

SPPI criteria assessment

Based on facts and circumstances at time of initial recognition

Equity instruments FVOCI

Election made based on facts and circumstances at DIA i.e. an entity determines whether asset is held for trading as if it had acquired the asset on the DIA

Fair value option

Designate or revoke designations of FA and FL based on facts and circumstances at DIA

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Transition – impairment

Significant increase in credit risk

Assessed at DIA since date of initial recognition

Using reasonable and supportable information available without undue cost or effort

Not available without undue cost or effort

Recognise lifetime expected credit losses until derecognized

Unless low credit risk at reporting date

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Transition – hedge accounting

Policy Choice

To apply MFRS 9 hedge accounting or to continue to apply MFRS 139.
Must meet qualifying criteria at DIA if apply MFRS 9

Rebalancing

Hedge relationships under MFRS 139 that qualify under MFRS 9 can continue, gain or loss on rebalancing to be recognized in P/L

Prospective application

On DIA, hedge relationships under MFRS 139 should move to MFRS 9. Restatement of comparatives is not required

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